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INTEREST

North Dakota State Investment Board

March 2003



WHAT DIDN'T HAPPEN IN '02 AND WHAT IT MEANS FOR '03

By Louis Rukeyser

July will mark the twentieth anniversary of the death of Herman Kahn, but – as is appropriate for one who liked to call himself a “futurist” – at least one of his annual habits seems especially apropos for savvy investors at the start of 2003. Kahn would come up with a list of all the widely expected terrible things that did not happen in the previous year. Then, as now, the conventional news media routinely accentuated the negative, the stock market was just emerging from an extended downdraft, and pessimism pervaded the economic and global consensus. In reality, what the future actually held included the longest boom in American history, a skyrocketing stock market and a historic U.S. victory in the Cold War. Those smart enough then to disregard the prevailing gloom and plan – and invest – with a sturdier heart have been the big winners of the past generation.

Once again, optimism seems counter-intuitive to many investors who have suffered through three disappointing years (even after so many spectacular advances). So let's honor the Kahn tradition by pointing out some of the terrible things that did not happen in 2002, and what that may mean for 2003.

1. The U.S. economy did not collapse into a double-dip recession. In fact, economic growth continued through the year. The pace was mild, as is normal after an exceptionally mild recession,

but the direction was unmistakably upward. Now, with monetary policy highly stimulative and fiscal policy about to become even more so, growth can be expected to accelerate, particularly if we can put some of the global uncertainties behind us. The slightly weaker dollar, while it's a pain for U.S. tourists, makes U.S. manufacturing exports more attractive. The jobs picture is always a lagging indicator (employers tend to hold on to workers, heading into a slowdown, and to go slow in rehiring as conditions improve) should brighten as corporate profits strengthen.

2. Despite what we were told, it wasn't “the bleakest Christmas in 30 years” after all. Oh, how some Americans – including, alas, most of my media colleagues – love to flagellate us about our economy. Actually, total retail sales this past Christmas totaled the highest dollar-volume in our nation's history. And reports on real sales continue to be revised upward. In short, this past Christmas' retail sales set an all-time record. What was “down” was the “rate of increase.” As my friend, the veteran broadcaster Paul Harvey, put it to me: “Let's encourage however we can some instruction in elementary economics in journalism schools. Americans have been led to expect an escalating increase every year and when the numbers fall below the anticipated increase, our economy is made to sound near bankrupt. Why would anybody want to put an ugly Halloween fright mask on Santa Claus?”

Continued inside...



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Steve Cochrane, CFA
Executive Director/CIO

FROM THE DIRECTOR'S CHAIR

If you start your day with the morning crew on CNBC, checking prices on the European bourses, noting the price of North Sea Brent crude oil and monitoring domestic futures before the opening, you need a break! But you won't take it. You'll begin your work day and then take your first glimpse at "the market" and the latest economic news releases. Check into an analysis of global politics and the uncertainties of pending war and the market's reaction as the day unfolds. Watch those interest rates wiggle around. Read some research reports on telecom stocks. And, as a hardcore, you return home at night to see what Lou Dobbs and Kudlow and Kramer have to say. Throw in a little too much coffee, some Krispy Kremes your co-worker brought from Fargo, your brokerage statement and a few of life's usual

dislocations of happiness, and by bedtime, your only option is to watch Headline News and prepare to start all over again.

Once a month, I do get a break. It comes in the form of a newsletter written by the veteran financial journalist, Louis Rukeyser. I appreciate his very long term view of the market and his ability to put market chaos into understandable order by helping me remember that I am an investor, not a speculator. After a year like 2002, it does the soul good to read Louis' take on the market and take a moment to count a few blessings we might have overlooked. His year-end market summary is reprinted in this newsletter. I hope you enjoy it as I have, and let's hope that next year, Lou has a little more fun to write about!

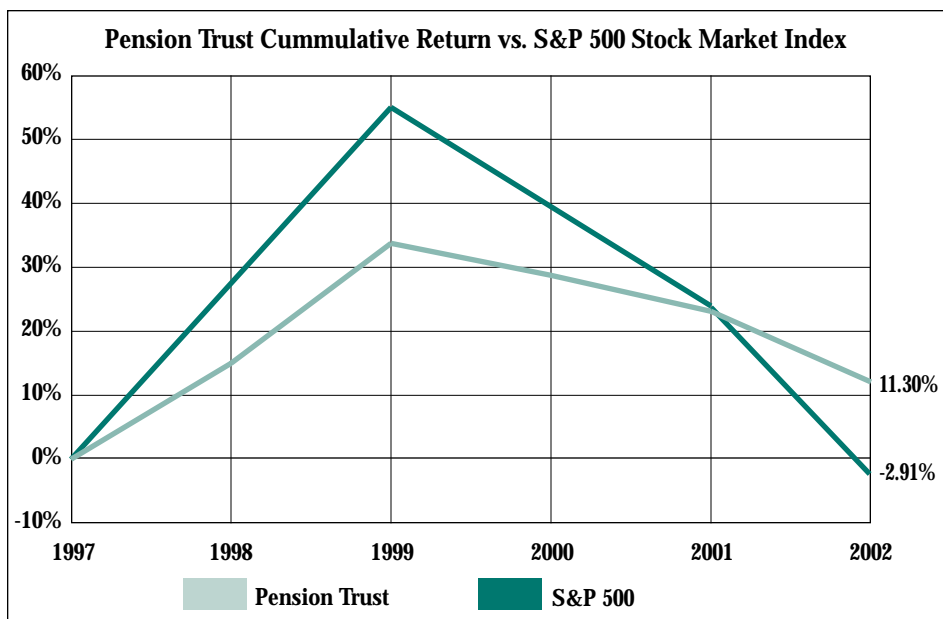
FIVE YEARS...

*Five years, what a surprise.
Five years, my brain hurts a lot.
Five years, that's all we've got.*

Well, who was to guess what five-year period rock star David Bowie may have been singing about back in 1972 when he shared these ominous lyrics with the world? We may never know, but a case could be made that the last five fit the description pretty well!

For the five years ended December 31, 2002, the stock market has actually lost money. Even after you take into account the two huge investment return years of 1998 and 1999, the five-year period would leave you asking, "that's all we've got?" After gaining nearly 60 percent in '98-'99, the reversal in fortune has dragged the five-year cumulative return into the loss column. The S&P 500 stock market index, the most widely recognized index representing 500 of the largest U.S. public companies, finished the five years down 2.91 percent. No wonder his brain hurts a lot!

As our readers know, the State Investment Board (SIB) invests on behalf of the Public Employees Retirement System (PERS) and the Teachers' Fund for Retirement (TFFR), as well as many other funds. PERS and TFFR are invested together in a commingled fund to maximize efficiencies. This fund is called the



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WHAT DIDN'T HAPPEN... *Continued from front page*

3. The U.S. went through the year without sustaining another major terrorist attack. This is a sensitive one, because as we all know we can never say “never again.” Indeed, cautionary voices such as that of my old friend, Donald Rumsfeld, call another such attack “inevitable” – lest anyone ever be tempted to relax (or blame the government for not warning us). But the overriding, and possibly surprising, truth is that if I had told you after Sept. 11, 2001, that our country would not be the victim of another major terrorist attack at any time in 2002, you probably would have dismissed me as Pollyanna reincarnate.

4. Stocks did not continue unendingly south. This past year will certainly not be a prime choice of investors for a remake of that Hollywood classic, “My Favorite Year.” It was, as we all know, another bitter setback. Just when stocks were beginning to recover from their earlier series of woes – the puncturing of the Internet balloon, the Fed-induced recession, the shattering events of 9/11 – we were blindsided again, this time by the spectacular corporate and accounting scandals. Once more, overly negative media coverage exaggerated the problem, leaving the impression among many stunned investors that absolutely no company’s numbers could ever be trusted again.

As the year unfolded, the combination of new regulatory oversights and an increasing Wall Street willingness to err on the downside tempered investor cynicism. Indeed, one could argue that the market has lately been showing remarkable resilience in the face of such new concerns as the possibility of one or two wars in 2003. The pattern increasingly reminds me of 1974, when the healing process clearly began two or three months before the actual bottom. And, as that incomparable mutual-fund manager, Bill Miller, argues in *The Rukeyser Interview* this month, the latest, October-2002 bottom looks increasingly

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for real. Bill makes a lot more sense to me than the perpetual gloomsters like the “wave and cycle” charlatans who were announcing the end of stocks, not to mention Western civilization, 15 years ago. Wrong again, guys.

So is everything hunky-dory as we move through 2003? Not so’s you’d notice. The international situation remains a grim question mark. The sooner and more successfully it can be removed the better for investors. The economy is plainly still well short of boom conditions, but the good news is that – as usual since the Millennium – most observers are too ready to interpret even upbeat news darkly. A fresh example is the initial negative reception of an earnings report from Intel, even though it contained better-than-expected news in such presumably unimportant areas as profits, revenues, margins and future guidance. The market seized instead on an easily reversible reduction in capital spending, an area in which companies in general and Intel in particular have proved astoundingly poor forecasters. As the economy improves over the next 12 months, so assuredly, will business capital spending.

We can also take heart from another often-reliable contrary indicator: the Investors Intelligence survey of financial advisers fell to a 10-week low at the beginning of 2003, with fully 52.3 percent of advisers predicting either a minimum – 10 percent selloff or an outright disaster. (Stocks then proceeded to get off to their best start in years, but who’s counting?) When that many “advisers” get that pessimistic, it

usually means they’ve already sold and departed – and the connotations are bullish.

Another wild card on the potentially positive side is true tax reform, lowering rates across the board and helping investors by slashing or even eliminating the dividend tax. This is still a long way from a done deal in 2003, but the market’s own day-to-day reactions to the news from Washington make clear that most investors would regard such change as highly favorable. Those who reflexively bemoan the effect on the deficit miss a number of important points. For starts, jump-starting economic growth has repeatedly been shown to be the best way to increase government revenues. Second, interest rates do not mindlessly track the deficit, as we saw again in the 1980s when rates came down despite massive red ink. Third, and perhaps most important, those who resist meaningful tax cuts are – often deliberately – obscuring the more-important role of unchecked government spending in creating the deficit problem. So-called discretionary spending is growing at a disturbing 8 1/2 percent rate, and neither side in Washington seems willing to do anything significant about it. (After all, there’s an election every two years, so why trouble yourself with boring stuff like arithmetic?)

To sum up, nirvana in 2003, no – but catastrophe, absolutely not. On balance, the horizon is beginning to clear. When it does, those investors who got or stayed in ahead of the crowd will have an extraordinary payoff. Herman Kahn could have told you that.

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FIVE YEARS *Continued from inside*

Pension Trust. For the five years ended December 31, 2002, the Pension Trust Fund is up 11.3 percent. That's all we've got. But in this upside down world, that seems pretty good. What a surprise.

We have discussed asset allocation on these pages many times, but in the big picture, it boils down to two types of investments, stocks and bonds. Over the last five years, and contrary to most five-year periods in the U.S. since 1926 (the beginning of modern recorded financial history), bonds did better than stocks. So, the more bonds you held relative to stocks, the better. PERS holds more bonds as a percent of the fund than TFFR. So, as night follows day, so did the better returns go to PERS for this particular period.

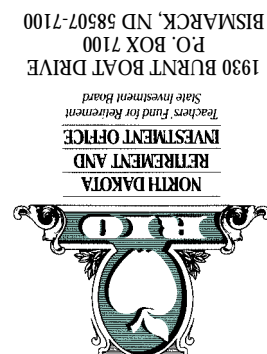
For this time span, PERS has had a cumulative return of almost 13 percent. TFFR was up 6.3 percent, losing the edge it had built up over the first three years as stocks reversed course. Now, keep in mind that these two funds are invested in different proportions of stocks and bonds for plan specific reasons. The returns between the two funds are not directly comparable.

When you consider how poor the stock investment environment has been for five years, you almost find a level of comfort with the returns we have experienced. But when you take into consideration an assumption that our plans will earn 8 percent each year, the comfortable feeling quickly fades. My brain hurts a lot.



2002 ANNUAL FINANCIAL REPORT AVAILABLE

The North Dakota Retirement and Investment Office Comprehensive Annual Financial Report (CAFR) may be viewed from our website, www.discovernd.com/rio or a copy may be requested by contacting the administrative office. This report is a complete review of the financial, investment, and actuarial conditions of the State Investment Board and the Teachers' Fund for Retirement.



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